Gabriël van Gelder*
and Boudewijn Niels**

Tax Treatment of Hybrid Finance Instruments

The authors consider the Dutch tax treatment of hybrid finance instruments in light of the debate within the OECD, G20 and European Union on tax avoidance by multinational enterprises and recent case law developments in the Netherlands.

1. Introduction[1]

In many jurisdictions, the distinction between equity and debt for tax purposes is of great importance. In the Netherlands for instance, interest deduction may be denied if debt can be characterized as equity for tax purposes. To the surprise of many, recently Dutch lower courts ruled that under certain circumstances equity could be treated as debt for tax purposes.[2] Some of the considered arguments were based on the notion that pursuing equity treatment of a finance instrument having certain debt features could be seen as an abuse of tax law. Although the Dutch Supreme Court has not yet taken a final decision in both cases, it is clear that the tax treatment of hybrid finance instruments is in the spotlight. This is also demonstrated by the interest that hybrid finance instruments attract from supranational organizations like the OECD and the G20 and from the European Commission in their fight against tax avoidance by multinational enterprises.

This article will discuss the tax treatment of hybrid finance instruments in the Netherlands in view of these developments. It particularly focuses on mismatches between the tax systems of different jurisdictions in the treatment of payments on hybrid finance instruments. For purposes of this article, "hybrid finance instrument" is defined as a finance instrument which is considered debt in country *A* where a payment on the instrument is tax deductible, while in country *B* the instrument is treated as equity and the proceeds constitute a tax-exempt dividend.

First, the current debate within the European Union, the OECD and the G20 on tax avoidance in general and the use of mismatches by hybrid finance instruments in particular, are examined, followed by a brief overview of how debt and equity are treated for Dutch tax purposes and what their distinguishing characteristics are, also in light of both recent court cases. The Dutch tax treatment of the use of hybrid finance instruments is considered, and whether Dutch legislation needs to be amended in view of these developments is discussed.

2. International Fight against Hybrid Finance Mismatches

2.1. European Commission

On 6 December 2012, the European Commission presented its action plan to strengthen the fight against tax fraud and tax evasion.[3] The area of mismatches, which deals with issues such as hybrid loans and hybrid entities, and differences in the classification of such structures between jurisdictions, is an area of particular importance.[4] In view of this, the European Commission encourages Member States to include a clause in tax treaties concluded with other EU Member States and with third countries to resolve a specifically identified type of double non-taxation. Furthermore, it suggests the amendment of the Parent-Subsidiary Directive to ensure that its application does not inadvertently prevent effective action against double non-taxation in the area of hybrid finance structures.[5] The European Commission also recommends the use of a common general anti-abuse rule. This would help to ensure coherence and effectiveness in an area where the practice of Member States varies considerably.[6] However, no specific draft clauses, amendments or rules were proposed in December 2012.

On 14 May 2013,[7] the Economic and Financial Affairs Council adopted conclusions on tax evasion and tax fraud, highlighting the need for a combination of efforts at national, EU and global levels, and confirming support for work within the G8, the G20 and the OECD on the automatic exchange of information.[8] The Council supports further efforts at the OECD level on base erosion and profit shifting (BEPS) and recalls the European Council Conclusions of 13 and 14 March 2013 on the need for close cooperation with the OECD and the G20 to develop internationally agreed standards for the prevention of base erosion and profit shifting. Furthermore, the Council invites the Code of Conduct Group (Business Taxation) to continue its work on developing solutions to the problems caused by the mismatched treatment of hybrid entities and instruments. No concrete measures have been adopted by the Council on the abuse and mis-

* Advocaat and tax lawyer, DLA Piper, Amsterdam. The author can be reached at gabriel.vangelder@dlapiper.com.
** Advocaat and tax lawyer, Linklaters, Amsterdam. The author can be reached at boudewijn.niels@linklaters.com.

1. This article was finalized on 16 June 2013 and therefore does not take into account any subsequent developments.
2. NL: AC Amsterdam (Gerechtshof Amsterdam), 7 June 2012, 11/00174, VN 2012/40.11; NL: AC The Hague (Gerechtshof Den Haag), 14 Aug. 2012, 11/00969, NTFR 2013/ 70.
3. European Commission, 6 Dec. 2012, IP/12/1325 and COM(2012) 722 final, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf.
4. European Commission, *supra* n. 3, at 6, 9.
5. European Commission, *supra* n. 3, at 9.
6. European Commission, *supra* n. 3, at 6.
7. Brussels, 14 May 2013, 3238th Council meeting, Economic and Financial Affairs.
8. Available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137122.pdf.

match of hybrid finance instruments. In the week thereafter, the European Parliament adopted a resolution regarding the fight against tax fraud, tax evasion and tax havens,[9] and urges Member States to swiftly implement the Commission's proposals. On 22 May 2013, the European Council adopted certain conclusions on tax fraud and tax evasion in line with the conclusions of earlier meetings of the European Commission and European Parliament.[10] However, these general recommendations are not very specific and no detailed measures have been proposed to target the abuse of hybrid finance instruments.

2.2. OECD

The G20, in its November 2012 meeting, requested the OECD to report on its research on base erosion and profit shifting. The OECD report was published on 12 February 2013 and was welcomed by the G20 Finance Ministers and Central Bank Governors during their summit in February 2013 in Moscow, where they expressed their determination to develop measures to address base erosion and profit shifting and to take necessary collective actions.[11] According to the OECD report, among the most important key pressure areas are international mismatches in relation to the classification of entities and instruments.[12] It is explicitly noted that hybrid finance instruments are used to achieve low or no taxation at the level of the recipient.[13]

This is not the first time that the OECD warns of its concern over hybrid mismatches. In 2010, in its report titled "Addressing Tax Risks Involving Bank Losses", the OECD warned that mismatch situations may potentially raise policy issues, in particular where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions.[14] In the 2011 OECD report titled "Corporate Loss Utilisation through Aggressive Tax Planning", finance instruments were addressed as one of three essential risk areas, as they may createartificial losses or losses that are taken into account more than once, which is, according to the OECD, a form of aggressive tax planning.

In March 2012, the OECD published a report titled "Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues", which addresses four types of hybrid mismatch arrangements, namely (i) hybrid entities, (ii) dual resident entities, (iii) hybrid instruments and (iv) hybrid transfers. The effects of the hybrid mismatches could be that a double deduction is claimed for the same contractual obligation. Another effect could be the so-called deduction/no inclusion scheme, under which a deduction is created in country *A*, whilst the corresponding benefit is not taxed in country *B*. Lastly, a foreign tax credit may be created, which would arguably not be available.[15]

According to the OECD, a preliminary conclusion is that hybrid mismatch arrangements that comply with the law of two countries but achieve non-taxation in both countries, which result may not be intended by either country, generate significant policy issues affecting for example tax revenue, competition, economic efficiency, transparency and fairness.[16]

In the Base Erosion and Profit Shifting report, the OECD did not propose any specific measures, but it proposes to develop a plan to provide countries with instruments – domestic and international – aimed at better aligning rights to tax with real economic activity.[17] It was proposed that such initial comprehensive action plan be presented in June 2013 at the next meeting of the Committee on Fiscal Affairs, but it was not published yet.

The OECD report titled "Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues", already described various policy options concerning hybrid mismatch arrangements. The OECD considered that hybrid mismatch arrangements could be reduced by eliminating commonly exploited differences in the tax treatment of entities, instruments and transfers, but the OECD believes that it is very unlikely that one global harmonized approach will be agreed upon by the various OECD member countries. Furthermore, although general anti-avoidance rules – including judicial doctrines such as "abuse of law", "economic substance", "fiscal nullity", "business purpose" or "step transactions" – are an effective tool, they may not always provide a comprehensive response to cases of unintended double non-taxation through the use of hybrid mismatch arrangements.[18] Obviously, the measures are not concrete or specific enough to deal with this problem. Therefore, the OECD notes, specific anti-avoidance rules could have more affect, such as a rule which states that the interest is not deductible if the income received on the loan is not taxed at a certain minimum level in the jurisdiction of the recipient.[19] These rules do not specifically deal with hybrid finance instruments, but could be used to target abuse.

Finally, the report mentions the significant potential of rules specifically addressing hybrid mismatch arrangements. Under these rules, the domestic tax treatment of an entity, instrument or transfer involving a foreign country is linked to the tax treatment in the foreign country, thus eliminating the possibility for mismatches. As the tax treatment in one country depends on the tax treatment

9. European Parliament resolution of 21 May 2013 on Fight against Tax Fraud, Tax Evasion and Tax Havens (2013/2060(INI)), available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2013-0205+0+DOC+XML+V0//EN.
10. European Council, 23 May 2013, EUCO 75/1/13 REV 1, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/137197.pdf.
11. Available at www.g20.org/events_financial_track/20130215/780960861.html.
12. OECD, Addressing Base Erosion and Profit Shifting (2013), at 47.
13. OECD, Addressing Base Erosion and Profit Shifting (2013), at 40.
14. OECD, Corporate Loss Utilisation through Aggressive Tax Planning (2011).
15. OECD, Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues (2012), at 7.
16. OECD, Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues (2012), at 11.
17. OECD, Addressing Base Erosion and Profit Shifting (2013), at 8.
18. OECD, Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues (2012), at 13.
19. OECD, Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues (2012), at 14.

in the second country, the application of the rule may, however, be rather complicated.

2.3. Conclusions

It is recognized by the G20, the OECD and the European Commission that mismatches of hybrid finance instruments are one of the most important tools for multinationals in lowering their worldwide corporate income tax liability and that therefore the use of such instruments in tax avoidance schemes should be prevented. Until now, however, no concrete measures have been proposed, except for (i) the OECD's suggestion to have specific anti-avoidance rules and rules specifically targeting hybrid mismatch arrangements and (ii) the European Commission's suggestion to amend tax treaties and the Parent-Subsidiary Directive (90/435). Thus, it seems quite difficult for supranational organizations to target the abuse of hybrid finance instruments. Therefore, it should be reviewed to what extent national legislation provides for measures targeting abuse of hybrid finance instruments. For a discussion of the extent to which the Dutch tax rules on hybrid finance instruments provide for the recommendations proposed by the OECD and the European Commission, *see* section 5.

3. Tax Treatment of Equity and Debt in the Netherlands

3.1. General description of tax treatment of equity and debt

Under Dutch tax law, as in many other jurisdictions, remuneration for debt (interest) is generally deductible, while remuneration for equity (profit distribution) is not deductible. Furthermore, in principle, 15% Dutch dividend withholding tax is levied on profit distributions, while no Dutch withholding tax is levied on interest payments.[20] Both interest and profit distributions are taxable in the hands of the recipient. Dutch corporate tax law provides for an exemption, by means of the participation exemption (*deelnemingsvrijstelling*), of income derived from equity investments in a subsidiary if a shareholder owns at least 5% of the nominal paid-in share capital in the subsidiary, provided that the shares are not held as a portfolio investment. Even if the shares are held as a portfolio investment, this participation exemption may still apply if either (i) the subsidiary is subject to a tax on profits resulting in reasonable taxation according to Dutch standards (*subject-to-tax test*) or (ii) less than 50% of the assets of the subsidiary are low-taxed free passive portfolio investments (*asset test*).

3.2. Characterizing debt as equity for Dutch tax purposes

A number of court cases have resulted in a defined framework to reclassify debt as equity for Dutch tax purposes. In principle, whether a financial instrument should be considered debt or equity is determined on the basis of its civil law classification.[21] In the *Caspian Sea* case,[22] the Dutch Supreme Court made clear that the essential characteristic of a loan is the repayment obligation of the debtor. This means that if the recipient of a certain financing is not obliged to repay the amount, the financing is, in principle, not considered a loan.[23] There are, however, three exceptions as a result of which debt for civil law purposes is nevertheless considered to be – or is at least treated as – equity for Dutch tax purposes. These exceptions are sham loans (*schijnleningen*), loss financing loans (*bodemlozeputleningen*) and participating loans (*deelnemerschapsleningen*).

A participating loan is codified[24] and under this provision, deduction of interest paid on a loan is not allowed if the loan is granted under such circumstances that in fact it functions as equity of the borrower. To characterize debt as a participating loan, the following conditions developed under Dutch case law must all be met:
- the remuneration on the loan is dependent on the profit of the borrower;
- the loan is subordinated to the claims of all other creditors; and
- the loan has no term or is perpetual (a loan having a term in excess of 50 years is considered to have met this condition).[25]

Therefore, a loan qualifying as debt for civil law purposes which is not a sham loan, a loss financing loan or a participating loan, is considered debt for Dutch tax purposes.

3.3. Recent developments in Dutch case law: reclassification of equity into debt?

As yet, neither the Dutch legislator nor the Dutch Supreme Court has made any exceptions to the rule that equity for civil law purposes is considered equity for tax purposes. However, two recent appeals court cases suggest that in the view of some, a reclassification of equity into debt may be justified under certain circumstances.

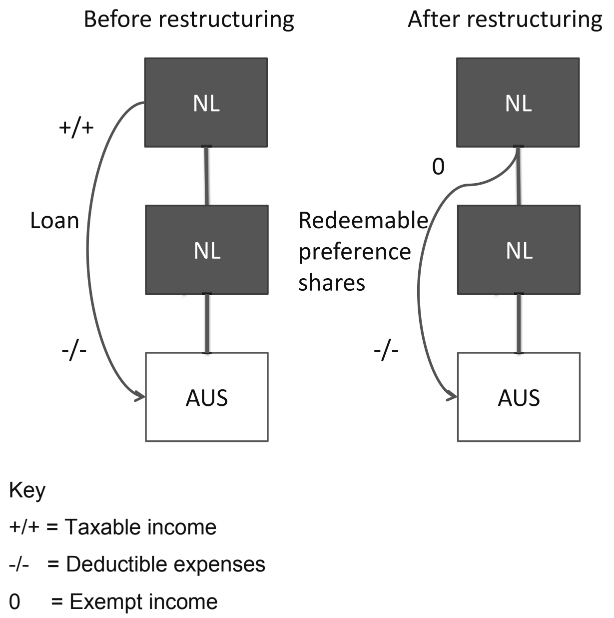
3.3.1. Australian redeemable preference shares

A Dutch corporate taxpayer had an indirect 16% interest in an Australian company to which it had granted shareholder loans. After a restructuring in 2004, the Dutch taxpayer received newly issued redeemable preference shares in the Australian company and the shareholder loans were repaid. The characteristics of the redeemable preference shares were that (i) they annually pay a cumulative preferred dividend of 8%, increasing to 12% of the amount contributed on the redeemable preference shares, (ii) they have basically no voting rights and (iii) they will be redeemed within ten years.

20. Certain exceptions apply to this rule.

21. NL: SC, 27 Jan. 1988, BNB 1988/217.
22. NL: SC, 8 Sept. 2006, BNB 2007/104.
23. This raises the question as to whether e.g. a mandatory convertible bond should not be regarded as debt, but as equity. However, as yet, this view is neither confirmed nor rejected by the Supreme Court or the State Secretary of Finance.
24. Art. 10.1.d Corporate Income Tax Act 1969 (*Wet op de vennootschapsbelasting* 1969).
25. NL: SC, 25 Nov. 2005, BNB 2006/82.

Figure 1



Where previously the Dutch taxpayer was taxed on the interest received on the shareholder loans, after the restructuring, the participation exemption is applied to the income derived from the redeemable preference shares. As a consequence, although the payments on the redeemable preference shares were still deductible under Australian tax law, they were no longer taxed at the level of the Dutch taxpayer. This court case revolved around two questions, namely (i) should the redeemable preference shares be reclassified as debt and (ii) should the application of the participation exemption be denied on the basis of the abuse of law doctrine.

The Lower Court[26] ruled that the redeemable preference shares were in fact a loan because they had a fixed maturity of less than 50 years, a fixed interest rate which was not dependent on the profit of the Australian company and the redeemable preference shares did not have voting rights. Furthermore, in the financial statements of the creditor and of the debtor, the redeemable preference shares were taken into account as a receivable and a payable, respectively.

On appeal, however, the Court of Appeal[27] stated that the redeemable preference shares were comparable to preference shares issued by a Dutch company to which the participation exemption would have applied. Therefore, the redeemable preference shares could be considered as a participation within the meaning of the participation exemption provisions and as a consequence, the income was exempt. In his advice to the Dutch Supreme Court, the advocate-general[28] argued that the financing of a company, under Dutch law, qualifies as equity if the amount is subject to claims from creditors of the company, and is reduced if the company realizes losses. Whether the redeemable preference shares meet this criterion must be determined on the basis of Australian law. In this respect, according to the advocate-general, it is particularly relevant what the position of the redeemable preference shares holders compared to subordinated creditors would be in the event of bankruptcy.

Under the abuse of law doctrine, transactions may be reclassified or ignored for tax purposes if (i) the predominant purpose of the transactions was to avoid levying the tax and (ii) not levying the tax as a result of these transactions would be against the aim and purpose of the relevant tax rules.[29] In the redeemable preference shares-case, the Lower Tax Court considered this doctrine to apply, as the restructuring was driven by tax reasons because it was aimed at creating tax-exempt income while the corresponding expenses continued to be deductible in Australia.

However, the Court of Appeal ruled that the Dutch taxpayer had been entirely free to decide to invest in the Australian company by way of redeemable preference shares in the first place and there is no reason to conclude that it would, after the refinancing, no longer be free to do so. The advocate-general argued that the repayment of the loan followed by an investment in redeemable preference shares is not in conflict with the aim and purpose of Dutch tax law, nor in conflict with the aim and purpose of Australian tax law, as the Dutch taxpayer simply benefitted from a mismatch between two tax systems. There is no reason to consider the Dutch classification of the income as an exempt dividend more justifiable than the Australian classification as deductible interest. Finally, the advocate-general pointed out that the purpose of the participation exemption is to mitigate double taxation of the same profits, not to remove any unwanted consequences of mismatches in classification of cross-border finance instruments. As a consequence, the use of the redeemable preference shares cannot be regarded as violating the aim and purpose of the participation exemption, and the abuse of law doctrine therefore does not apply.

In the authors' opinion, the advocate-general is quite right in dismissing the abuse of law argument, and if that argument were to be followed by the Dutch Supreme Court it would be clear that the Dutch abuse of law doctrine as such does not restrict application of the participation exemption in cases where a hybrid finance instrument is used.

3.3.2. *Abuse of law: bank-refinancing case*

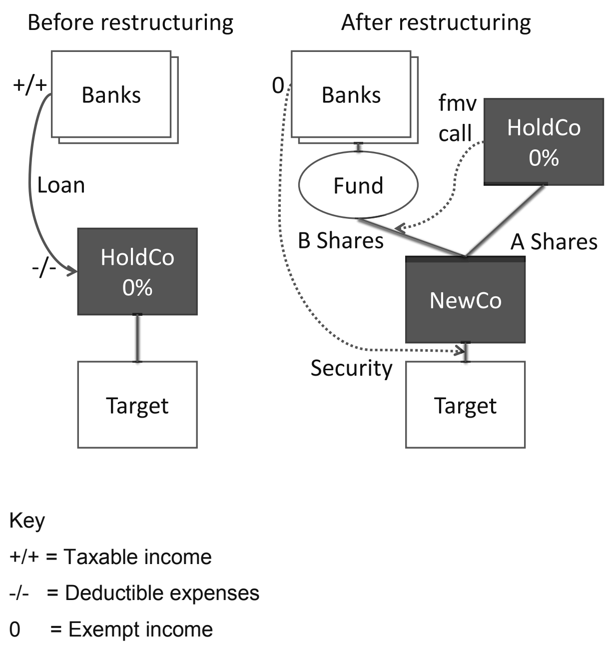
A consortium of banks had financed the acquisition of a listed Dutch company (Target) by a Netherlands Antilles company (HoldCo). At some point it was decided to restructure the financing in order to realize tax-exempt interest income for the banks and, therefore, lower borrowing costs for HoldCo. To this extent, the banks established a transparent fund which, together with HoldCo, incorpo-

26. NL: LC Haarlem (*Rechtbank Haarlem*), 25 Jan. 2011, 09/3391, VN 2011/32.12.
27. NL: AC Amsterdam (*Gerechtshof Amsterdam*), 7 June 2012, 11/00174, VN 2012/40.11.
28. Conclusion Advocate-general Wattel, 9 Jan. 2013, 12/03540, VN 2013/10.13.
29. NL: SC, 21 Nov. 1984, BNB 1985/32.

rated a new intermediate holding company (NewCo). This NewCo issued *A* shares and *B* shares. HoldCo contributed its shares in the Target on the *A* shares, while the banks – through the transparent fund – contributed the outstanding amount on the acquisition debt on the *B* shares. The dividend on the *B* shares was preferred and was a percentage of the total amount contributed on the *B* shares, which percentage was based on Euribor plus a margin. If the profit reserves attributable to the *B* shares were not sufficient to pay the dividend in a certain year, the dividend would be paid at the expense of the profit reserves attributable to the *A* shares or, if needed, at the expense of the share premium reserve of the *A* shares. Furthermore, the fund and NewCo agreed on a credit facility and a security package in relation to that.

As a result of the above restructuring, the banks each had more than 5% of the nominal paid-in share capital of NewCo, and took the position that the dividends received on the *B* shares were exempt.

Figure 2



Both the Lower Court[30] and the Court of Appeal[31] denied the application of the participation exemption, albeit on different grounds. The Lower Court considered that the economic result of the transaction was similar to the situation in which the banks would have granted a loan because, among other things, (i) the banks would receive their initially invested amount back from NewCo after a number of years, (ii) the banks did not bear any risks other than the risks that a normal creditor would run and (iii) the *B* shares paid a dividend based on Euribor plus a margin and this dividend was not contingent on the profits of NewCo. Furthermore, according to the Court, it would be in conflict with the aim and purpose of the participation exemption to exempt income which is, from an economic perspective, in fact interest income. It therefore considered the case to fall within the scope of a Dutch Supreme Court decision.[32] Based on this judgment, the legal form of a transaction can be reclassified for tax purposes if the legal form chosen by parties is not acceptable in view of the economic result of the transaction and given the aim and purpose of the applicable tax provisions. In principle, the taxpayer's intention is irrelevant for the purposes of applying the reclassification for tax purposes doctrine.

With reference to Dutch Supreme Court case law,[33] the Court of Appeal stated that in principle the civil law classification of a transaction is decisive unless, among other things, there appears to be an equity investment, where in reality the parties intended to grant a loan which they designed as an equity contribution. The Court of Appeal decided that the case at hand was within the scope of this sham transaction doctrine, as the banks designed an equity contribution, but in fact intended to grant a loan and for tax purposes; therefore the dividend should be considered taxable interest income.

To apply the sham transaction doctrine, it must be demonstrated that the taxpayer's actual intention differed from the apparent intention of the transaction. In this case, it was clear that the intention of the banks was to contribute equity in order to apply the participation exemption, which intention corresponds with the legal transactions. The Court of Appeal, however, did not convincingly make clear why it nevertheless believed the intention of the banks to be to grant a loan instead of equity.

Both rulings are somewhat surprising and, if followed by the Dutch Supreme Court, might have a severe impact on the application of the participation exemption to hybrid finance instruments. Based on the Lower Court ruling, one could argue that if the interest paid on a hybrid finance instrument is deductible, and the interest received is exempt, there is no double taxation of profits and, as the purpose of the participation exemption is to prevent profits from being taxed twice, exempting the "interest" would, according to the Lower Court, be in conflict with its aim and purpose. However, such conclusion would not be in accordance with how the participation exemption regime was developed over the years. Under the current participation exemption regime, income derived from operating subsidiaries is, in practice, always exempt, irrespective of the tax treatment of the subsidiary. Therefore, even if an operating subsidiary is not taxed at all, and therefore, no double taxation would occur, the participation exemption still applies – which is clearly not in conflict with the aim and purpose of the participation exemption.

30. NL: LC The Hague (*Rechtbank Den Haag*), 21 Nov. 2011, AWB 10/9097.
31. NL: AC The Hague (*Gerechtshof Den Haag*), 14 Aug. 2012, 11/00969, NTFR 2013/ 70.
32. NL: SC, 15 Dec. 1999, 33 830, BNB 2000/126.
33. NL: SC, 10 Aug. 2001, 33 662, BNB 2001/364.

4. Tax Treatment of Hybrid Instruments in the Netherlands

The Netherlands does not have specific tax rules addressing mismatches in the classification of finance instruments. However, there is a specific rule allowing application of the participation exemption to hybrid finance instruments. Furthermore, certain rules, including interest deduction limitation rules, under certain circumstances do take into account the tax treatment of finance instruments in the other jurisdiction.

4.1. Participation exemption

4.1.1. Availability of participation exemption to hybrid instruments

Following a number of court decisions classifying certain debt instruments as equity,[34] the Dutch legislator introduced legislation that on the one hand restricted deduction of interest paid on loans reclassified as equity, but on the other hand allowed the application of the participation exemption to income derived from participating loans, provided that the creditor had a qualifying participation in the debtor. However, if the debtor were resident in another country, to apply the participation exemption the Dutch company had to demonstrate that the payments on the participating loan were not deductible from the taxable profit in that other country in order to avoid exploiting international mismatches.[35]

As part of a major legislative operation to achieve a more competitive tax regime for international business, the Dutch legislator decided to amend the legislation regarding hybrid finance instruments, as it was considered to be too complex.[36] In this context, the non-deductibility requirement was dropped, as, in practice, it appeared to be difficult for taxpayers to prove. This was also justified, according to the Dutch legislator, because the Netherlands preferred a consistent approach to the treatment of equity and debt based on Dutch standards.[37] In the view of the State Secretary of Finance, it is not up to the Netherlands to prevent any mismatches following this amendment, but it is up to the other country to deny the deduction of the payment to the Dutch company.[38]

However, the fact that the non-deductibility requirement was abolished, does not mean that the Netherlands does not take into account the tax treatment of hybrids in other countries. First, the Dutch tax authorities will not give advance clearance regarding the application of the participation exemption to a hybrid finance instrument, if the taxpayer is using a mismatch between two tax systems to obtain a tax benefit.[39]

Furthermore, under current Dutch tax law, if a taxpayer has a qualifying participation, the participation exemption regime applies to a participating loan granted to the subsidiary, as well. If the participation is held as a portfolio investment, one must rely on one of the two tests discussed in section 3.1., which tests both take into account the tax treatment of the subsidiary.

4.1.2. Subject-to-tax test

This test may not be met if, among other things, significant deviations exist between the jurisdiction of the subsidiary and the Netherlands, such as a different classification of financing and a broader application of a participation exemption.[40] This means that where a subsidiary is allowed to deduct interest on a hybrid finance instrument which, for Dutch tax purposes, would be classified as equity and therefore would be non-deductible, or where a subsidiary is allowed to apply a participation exemption to income from a hybrid finance instrument which, for Dutch tax purposes, would qualify as debt and therefore the income would not be exempt, the subject-to-tax test may not be met. To meet this test, this may be problematic particularly if the foreign subsidiary is funded with a participating loan. Under certain circumstances, therefore, using a hybrid finance instrument may result in the participation exemption not being applicable and the income being taxed.

4.1.3. Asset test

If less than 50% of the assets of the subsidiary are low-taxed free passive portfolio investments, the asset test is deemed to be met. Free passive portfolio investments are portfolio investments not used within the day-to-day business of the subsidiary, but may also include intra-group receivables. Whether a certain free passive portfolio investment asset is low taxed, is determined on the basis of the same rules as when applying the subject-to-tax test.[41] This means that the participation exemption may not apply if, for instance, the assets of the subsidiary to a large extent consist of hybrid financing receivables from group companies, which are treated as equity from a Dutch tax perspective, but to which the participation exemption applies in the country of residence of the subsidiary.

4.2. Interest deductibility

Dutch corporate tax law provides for a number of rules limiting the deduction of interest, two of which take into account the tax treatment of the payments received by the creditor.

4.2.1. Anti-base erosion rule[42]

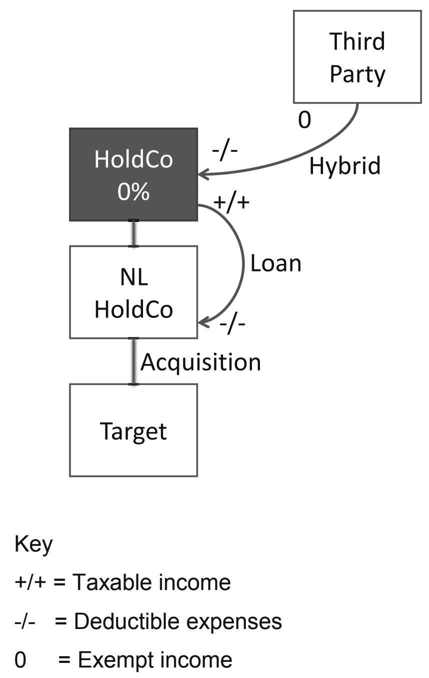
The anti-base erosion rule aims at limiting interest deduction on intra-group debt obtained to fund certain equity transactions. Interest on such intra-group debt is not deductible unless it is demonstrated that an exception applies, i.e. (i) both the debt and the equity transactions

34. Most notably, NL: SC, 11 Mar. 1998, BNB 1998/208.
35. NL: Parliamentary history, 2001/2002, 28 034, no. 3, at 28.
36. NL: Parliamentary history, 30 572, no. 3.
37. NL: Parliamentary history, 30 572, no. 8, at 41.
38. NL: Parliamentary history, 30 572, no. C, at 19.
39. NL: Decree of 30 Mar. 2001, RTB2001/1379M.
40. NL: Parliamentary history, 2009-2010, 32 129, no. 3, at 61-65.
41. NL: Parliamentary history, 2009-2010, 32 129, no. 3, at 65-68.
42. Art. 10a, Corporate Income Tax Act 1969 (*Wet op de vennootschapsbelasting* 1969).

are driven by business reasons or (ii) the interest received by the creditor is subject to tax at a rate of at least 10% on the profits calculated on the basis of Dutch standards.

Obviously, the second exception is not available if the intra-group debt qualifies as equity in the hands of the creditor and the interest payments are therefore exempt. The first exception may be available where, for instance, the acquisition of shares in a company from a third party, driven by business reasons, is financed back-to-back with third-party debt.[43] However, using a hybrid finance instrument may have an impact on its availability. Recently,[44] the State Secretary of Finance has taken the position that if third-party debt is, for tax reasons, diverted to a related company, this exception does not apply. An example of this is seen where external funding is attracted through the issuance of hybrid finance instruments which are treated as debt by the related group company, but treated as equity in the hands of a third party. According to the State Secretary of Finance, this is a mismatch resulting in the diversion's not being considered to be driven by business reasons. *See* Figure 3.

Figure 3



4.2.2. Long-term, low-interest loan

For Dutch tax purposes, if remuneration on a related party transaction is not arm's length, it is adjusted to an arm's length remuneration. To mitigate the risk of international mismatches, i.e. no or little taxation at the level of the creditor (as the loan bears low or zero interest) and deduction of the higher adjusted arm's length interest in the Netherlands, a specific rule was introduced.[45] Under this rule, no (deemed) interest is deductible if paid on a long-term loan granted by a related party if the interest is significantly lower than an arm's length interest. As a result, in effect, hybrid loans that are treated as equity in the state of the creditor because of equity features (such as having a long-term and low interest), although they are treated as debt in the Netherlands, do not result in deductible interest.[46]

4.3. Dividend withholding tax

The Dutch Dividend Tax Act (*Wet op de dividendbelasting* 1965) explicitly states that payments made on a participating loan are subject to dividend withholding tax and therefore have the same treatment as other equity instruments, including the exemption from dividend withholding tax in the case of payments to certain qualifying EU/EEA resident companies. Also, the refund of dividend withholding tax available to, for instance, pension funds is equally applicable to dividend tax withheld from payments on participating loans. Furthermore, a credit of dividend tax withheld on payments on a participating loan is generally available for Dutch individual and corporate taxpayers.

4.4. Tax treaties

In its partnership report and in the Commentary to article 23 of the OECD Model Convention, the OECD discussed mismatches in the classifications of hybrid entities.[47] The preferred solution for resolving these mismatches is that the residence state should follow the classification of the source state, i.e. if a hybrid entity is considered non-transparent in the source state, it should be – for purposes of the relevant tax treaty – considered a non-transparent entity in the residence state. The Netherlands explicitly indicated that it does not agree in general with this solution[48] and prefers to deal with this in each tax treaty separately and on a case-by-case basis.[49]

Although this only concerns hybrid entities, one would expect the State Secretary of Finance to take the same position in respect of hybrid finance instruments.[50]

5. EU/OECD Compatibility of the Tax Treatment of Hybrids in the Netherlands

The Netherlands takes as a starting point the Dutch civil law classification of a finance instrument. If an instrument is classified as debt, it is treated as debt for tax purposes,

43. NL: Decree of 25 Mar. 2013, BLKB2013/110M, no. 4.2.2.
44. NL: Decree of 25 Mar. 2013, BLKB2013/110M, no. 4.2.3.
45. Art. 10b Corporate Income Tax Act. *See* e.g. Parliamentary history, 30 572, no. 8, at 83 for the purpose of this rule.
46. The Dutch legislator recognized that this might result in double taxation in cases where the state of the creditor does adjust the interest received to an arm's length interest, as well, but this was considered to be justified as such double taxation was caused by related parties not dealing at arm's length conditions. *See* e.g. NL: Parliamentary history, 30 572, no. 8, at 83.
47. *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B*, paras. 32.1 to 32.7.
48. *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B*, Observations on the Article, para. 80; OECD Report, "The application of the OECD model takes convention to partnerships (1999)", Annex II, point 24.
49. Note on Tax Treaty Policy 2011 of the Ministry of Finance, at 35-36.
50. *See also* Advocate-general Wattel, 9 Jan. 2013, 12/03540, VN 2013/10.13, para. 7.3.

as well. There are three exceptions to this rule, but only the participating loan is indeed treated as equity: interest payments on a participating loan can be subject to dividend withholding tax, they are not deductible and, under certain circumstances, income derived from the participating loan is exempt under the participation exemption.

Generally, the classification in another jurisdiction is not relevant for the civil law classification of an instrument in the Netherlands. Therefore, instruments qualifying as equity in another jurisdiction may very well qualify as debt for Dutch tax purposes and vice versa. When determining the civil law classification of a foreign instrument, however, the foreign civil law aspects of that instrument can be relevant. In principle, the tax treatment of an instrument in another country does not impact the classification of the instrument as debt or equity in the Netherlands. However, in the recent redeemable-preference-shares case, to some extent the foreign tax treatment was taken into account when classifying the equity or debt treatment for Dutch tax purposes. Whether the Dutch Supreme Court would follow this approach remains to be seen.

This does not mean that the Netherlands does not take the foreign tax treatment of a hybrid finance instrument into account at all. As discussed in section 4., the participation exemption may not apply where using a hybrid finance instrument results in low taxation of the subsidiary and interest payments may not be deductible if paid on hybrid finance instruments, or where they are part of the funding structure. In the authors' opinion, the Dutch tax rules are in line with the OECD suggestions discussed in section 2.2. However, the Netherlands so far does not make its classification of a hybrid finance instrument dependent on the classification for tax purposes in the other jurisdiction. The authors believe this is to some extent justified, as otherwise the application of the tax rules would become rather complex. Furthermore, this is also in accordance with the Dutch approach to hybrid entities, which classification for Dutch tax purposes is also based on the civil law characteristics of those entities and does not take their tax treatment in the other jurisdiction into account at all.

In this context, it is interesting to note that the United Kingdom recently implemented a number of rules to address hybrid mismatch arrangements which do take the foreign tax treatment into account.[51] These rules apply, for instance, in circumstances where a payment qualifies for a tax deduction in the United Kingdom while the recipient is either not taxed on the receipt, or the tax charge is reduced.[52] Various conditions should be met to deny the deduction, including that (one of) the main purpose(s) is to achieve a UK tax advantage which is more than minimal.

With regard to the suggestions of the European Commission discussed in section 2.1., currently the Netherlands does not have specific provisions in its tax treaties addressing the abuse of hybrid finance instruments. Furthermore, it is expected that the Netherlands would not agree if the OECD Commentary were to reflect that the source country classification should prevail, as is the case with hybrid entity classification. Lower court decisions seem to suggest that the foreign tax treatment of a hybrid finance instrument is relevant for purposes of the application of Dutch abuse of law doctrine and the reclassification for tax purposes doctrine. However, it remains to be seen whether the Dutch Supreme Court would indeed agree to this. Finally, the Dutch participation exemption applies to all income derived from operating subsidiaries, even to payments received on hybrid finance instruments that were deductible in the other jurisdiction. It will be interesting to see whether the European Commission would propose to amend the Parent-Subsidiary Directive in such way that it requires the Netherlands to deny the participation exemption in such circumstances. However, such obligation for the Netherlands to tax income that it does not want to tax, could be in conflict with the general principle that Member States are – in principle – sovereign in tax matters as recognized by the European Court of Justice and the Treaty on the Functioning of the European Union.

6. Conclusion

Recently, a study committee on the taxation system established by the Dutch Ministry of Finance (*Studiecommissie belastingstelsel*) advised the further investigation of the possibilities of a fixed deduction on the profits made by a Dutch corporate taxpayer. The background of this was that in such scenario, the differences in the tax treatment of debt financing versus equity financing would be minimized. On 20 March 2013, the State Secretary of Finance informed the Dutch parliament that no research will be undertaken regarding differences in the tax treatment of debt and equity.[53] He stressed that in order to create certainty for taxpayers and to support the business climate conditions, it would be not feasible to perform such a review. However, in view of the court cases discussed in section 3., it seems not to be entirely clear how debt and equity are distinguished. Therefore, it would be advisable to perform such a review at some point in order to provide clear rules on how hybrid finance instruments should be treated for tax purposes.

Furthermore, the State Secretary of Finance noted[54] that it was not the intention that multinational enterprises should benefit from mismatches between jurisdictions to create a double deduction or to create a deduction without a corresponding taxable

51. NL: Secs. 231-257 Taxation (International and Other Provisions) Act 2010.
52. UK: INTM595030, Arbitrage: legislation and principles – deductions: rule B – deduction not matched by a taxable receipt, available at http://www.hmrc.gov.uk/manuals/intmanual/INTM595030.htm.
53. NL: Ministry of Finance (*Ministerie van Financiën*), 20 Mar. 2013, AFP/2013/62 M.
54. Seminar Ahead of Tax 2013, 21 Mar. 2013, Amsterdam.

profit, and he seemed not to be enthusiastic about hybrid finance instruments. However, no concrete measures have been announced so far and in the authors' opinion, the State Secretary of Finance is quite right in not announcing any measures, as the Netherlands already provides for sound rules limiting the opportunity to exploit hybrid finance mismatches from a Dutch tax perspective. In the authors' opinion, cross-border mismatches should be dealt with on an international level, as it cannot be said which classification is right and which is wrong. In particular the source country is in the position to deny the deduction of payments on hybrid finance instruments if needed.

Based on the findings in this article, the authors do not expect significant changes in Dutch tax legislation which might affect hybrid finance instruments. Therefore, the Netherlands remains an attractive jurisdiction from which to either issue hybrid finance instruments to (foreign) investors or hold an investment in hybrid finance instruments issued by a foreign (operating) subsidiary.